1992

Employee benefit plans industry developments - 1992; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK
ALERTS

Employee Benefit Plans Industry Developments—1992

Update to AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

The distress being felt by the U.S. and world economies continues to affect employee benefit plans in a number of ways. With interest rates at their lowest levels in years, many plans are moving their assets out of the bond market and various money-market investment vehicles and into other markets in hopes of earning higher investment returns. Some plan investment managers have adopted investment strategies that incorporate a variety of sophisticated techniques or specialized financial products, such as repurchase or reverse-repurchase agreements, futures, options, securitized lending arrangements, global securities, and certain derivative products. Collateralized mortgage obligations, real estate mortgage investment conduits (REMICs), and a myriad of securitized portfolio investments also are part of a growing list of specialized real estate investment securities that may be found in plan portfolios. Even more traditional plan investment vehicles may warrant heightened audit concern in the current economic environment. Many plans have invested in speculative or high-yield investments, such as junk bonds and certain types of real estate that may involve higher levels of risk. Audit risk considerations relating to such investments are discussed below.

Mortgage Loans and Real Estate

Real estate values have continued to decline or stagnate in many parts of the nation. Declining property values highlight the need to review investment portfolios to determine the appropriateness of accounting policies, especially those for valuing investments in real estate, and the extent of exposure to continuing weakness in the real estate sector.

Debt Securities

The continuing volatility of the junk bond market continues to present concerns for employee benefit plans holding investments in highly leveraged companies. A principal concern is the credit risk inherent in such higher risk investments. The current uncertain economic environment may add to concerns that issuers of such debt securities may default. In addition, the lack of an active market and buyers for such securities has raised concerns about the liquidity of investments in junk bonds. The lack of a ready market for investments in privately placed debt securities may raise concerns about the liquidity of such investments and may make it difficult to determine their market values.

Mortgage-Backed Securities

Plans with investments in mortgage-backed securities also face increased market risk in an unsettled economic environment because the market values of such investments fluctuate with the levels of mortgage prepayments and refinancings. In addition, mortgage-backed securities that are not guaranteed by financially stable guarantors may increase investors' credit risk.

Investment Contracts

As the economic distress continues into another year, the failure of several banks, savings institutions, and insurance companies has called into question the ultimate realizability of plans' investments with these institutions (for example, bank investment contracts, or BICs; guaranteed investment contracts, or GICs; and savings and loan investment contracts, or SLICs). Auditors should consider the financial stability of such institutions, especially with regard to their ability to fulfill their obligations concerning the return guaranteed.

In planning the audit of an employee benefit plan, auditors should consider the plan's investment strategy and policies and their audit risk implications. Specifically, auditors should carefully review asset valuations, considering whether amounts are properly reported in plan financial statements. Auditors should also consider whether plans' policies and procedures for identifying changes in value are adequate in light of current conditions.

Regulatory and Legislative Developments

U.S. General Accounting Office Report

In March 1992, the U.S. General Accounting Office (GAO) issued to Congress a report entitled *Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA*. The report included a number of recommendations to the AICPA intended to improve the quality of audits of employee benefit plans.

The report also included recommendations to Congress and the Department of Labor (DOL) to strengthen audit and reporting requirements to better protect plan participants. Among them was a recommendation that Congress amend the Employee Retirement Income Security Act of 1974 (ERISA) to eliminate the provision that permits plan administrators to direct independent auditors to perform limited-scope audits. Legislation to eliminate limited-scope audits has been introduced in Congress, but no action has been taken. Also included were recommendations that the DOL promulgate regulations to require plan administrators to report on the effectiveness of plan internal controls and to require auditors to report on plan administrators' assessments of these controls.

The report also recommends that the DOL require plan auditors (1) to report fraud and serious ERISA violations to the DOL promptly after discovery if plan administrators do not do so, (2) to participate in a peer review program that assesses the quality of at least one plan audit, and (3) to address their reports jointly to plan administrators and participants.

Auditors should be alert for any new requirements that may result from the GAO's recommendations.

PWBA Review of Plan Audits

The Department of Labor's Pension and Welfare Benefits Administration (PWBA) is continuing to implement a quality review program for ERISA audits. If, as a result of a quality control review, the DOL determines that significant substandard audit work has been performed, the auditor may be referred to the state licensing board or to the AICPA's Professional Ethics Division for investigation of the alleged substandard work. As of December 1991, 17 referrals had been made to state licensing boards, and 112 referrals had been made to the AICPA's Professional Ethics Division. The Ethics Division has resolved 57 of the PWBA referrals. The results of the investigations include the referral of 21 cases to the AICPA's Trial Board for further action, the generation of letters of recommended corrective action in 27 cases, the finding that no violation of professional standards was found in 4 cases, and the closing of 5 cases for other reasons. The deficiencies that resulted in referrals included the following:

- Auditor's reports were not filed.
- Auditor's reports did not comply with the provisions of SAS No. 58, *Reports on Audited Financial Statements*.
- Auditor's reports were not signed.
- Auditor's reports did not cover the required Form 5500 supplemental schedules.
- Limited-scope audit reports were filed for plans that did not qualify for the exemption.
- Statements of net assets were not presented in comparative form.
- Required note disclosures were not made or were incomplete.

As part of the quality review program, the PWBA has also performed on-site reviews of independent auditors' working papers. As of December 1991, 30 on-site working-paper reviews had been performed. These audits were selected for review based on the identification of potential significant deficiencies during desk reviews of Forms 5500, and on referrals from the PWBA's Office of Enforcement. The working-paper reviews resulted in the identification and referral of substandard professional work to the AICPA's Ethics Division, the rejection of plan filings, and referrals to the PWBA's Office of Enforcement for possible fiduciary violations.

PWBA Reporting Compliance Program

In addition to its quality review program for ERISA audits, the PWBA has also implemented a reporting compliance program to provide assurance that plan administrators comply with ERISA's reporting requirements, including those mandating the submission of complete and accurate reports and timely filings. To date, the PWBA has focused its efforts on plan administrators who file seriously deficient annual reports.

During 1991, the DOL imposed civil penalties of over $6,000,000 on plan administrators who filed deficient annual reports, in accordance with ERISA section 502(c)(2), which allows the DOL to assess penalties of up to $1,000 per day against plan administrators who fail to file timely and complete reports.

However, the PWBA is also strengthening its program to identify and penalize plan administrators who file their reports late or not at all.

Under the PWBA's expanded penalty assessment program, the following penalties may be assessed against plan administrators:

1. *Late Filers*—Plan administrators who voluntarily file annual reports for the 1988 and subsequent reporting years after the due date (including extensions) will be considered late filers and may be assessed $50 a day per plan for the period for which they failed to file.
2. *Nonfilers*—Plan administrators who fail to file and are identified by the PWBA will be considered nonfilers and may be assessed a penalty of $300 a day per plan. The penalty will continue to accrue at up to $30,000 per year for each plan until a filing is submitted.

Additional penalties for failure to file timely reports may be imposed on pension plan administrators by the Internal Revenue Service (IRS). Information concerning these penalties can be found in the Form 5500 Series instruction booklets available from the IRS.

The PWBA recently announced that it will give plan administrators a *one-time only* opportunity to file previously unfiled annual reports without incurring the full penalty. From March 23 through September 30, 1992, all plan administrators who voluntarily file previously unfiled annual reports for 1988 and subsequent reporting periods will be assessed $50 per day for each filing, up to a maximum of $1,000 for the period to September 30, 1992. Plan administrators who submit late filings after the grace period will be subject to the larger penalties. The IRS has indicated that it will favorably consider the good-faith efforts of pension plan filers who take advantage of the PWBA's failure-to-file grace period in determining what, if any, penalties it may impose. All annual reports received during the grace period will be subject to the usual DOL edit checks and review process. Plan administrators will be given an opportunity to correct deficiencies. Any deficiencies that remain uncorrected may result in the assessment of further penalties.

Plan administrators who wish to file previously unfiled annual reports during the grace period must (1) file with the IRS a complete Form 5500 Series Annual Report with all required schedules and attachments; (2) submit to the DOL a copy of the filing made with the IRS, with original signatures (facsimile copies will not be accepted); and (3) include with their submission to the DOL a check for the penalty amount, made payable to the U.S. Department of Labor.

Additional information concerning the assessment of the penalty is contained in DOL regulations 29 CFR 2560.502c-2 and 2570.60. Practitioners with questions concerning filing requirements and penalty assessments should contact the Division of Reporting Compliance at (202) 523-8776.

Form 5500C/R and Form 5500EZ Return/Report of Employee Benefit Plan

Plan administrators can now file Forms 5500C/R and 5500EZ electronically through the IRS Electronic/Magnetic Media Program for Employee Pension Plan Returns. The program allows the filing of returns on magnetic tape or floppy diskette, or via a modem. Filers are notified whether returns have been accepted or rejected, or whether the return is a duplicate of a previously transmitted return. (Such notification is not made to those who file paper returns.)

Auditors may wish to inform plan administrators that there are several advantages to electronic filing, including greater accuracy in filing, quicker service center response time (which may result in lower potential penalty assessments), and reductions in printing and shipping costs. Plan administrators may apply for the electronic filing program by calling the Andover Internal Revenue Service Center Electronic Filing Unit at (508) 474-9635.

Form 5500: "Reporting of Realized and Unrealized Gains and Losses on Investments"

Since 1988, line 35 of Form 5500 has required that realized and unrealized investment gains and losses be determined separately on the basis of revalued cost. However, because of the significant record-keeping and program changes needed to provide data on the basis of revalued cost, the DOL granted an additional year's relief of the requirement to report at revalued cost (for 1990 Form 5500 filings) to clients of banks who applied for an extension. As a result, noncompliance with the requirement to use revalued cost in 1988 and 1989 did not result in a rejection of the filing by the DOL. Plan auditors should be aware that *no* further extension has been granted, and that all plans are now required to report realized and unrealized investment gains and losses on line 35 of the 1991 Form 5500 using revalued cost. (It is important to note, however, that the DOL has indicated to the AICPA staff that the Schedule of Assets Held for Investment Purposes and any other required supplemental schedules should present historical cost information rather than revalued cost.) Any 1991 Form 5500 filings in which realized and unrealized gains and losses have been computed using historical cost may be subject to rejection and imposition of civil penalties under section 502(c)(2) of ERISA.

Audit and Accounting Developments

Audit Issues

Revised AICPA Audit and Accounting Guide. In June 1991, the AICPA Employee Benefit Plans Committee issued a revised edition of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans.* The revised guide is effective for audits of financial statements for plan years ending after December 15, 1991. The guide addresses new auditing standards, new types of benefit plans, changes in IRS and DOL reporting requirements, other changes in laws and regulations, and new types of investments available to plans.

The revised guide incorporates applicable audit and accounting pronouncements that were issued subsequent to the publication of the 1983 guide. The revised guide—

- Clarifies the accounting treatment for loans to participants of 401(k) plans.

- Provides guidance on the auditor's responsibility to read the financial information contained in Form 5500 and to consider whether the information and the manner of its presentation are materially consistent with the information and its presentation in the plan's financial statements.
- Provides an expanded discussion of the auditor's responsibility for reporting on prohibited transactions and guidance on the appropriate modification of the auditor's report when he or she concludes that a plan has entered into a prohibited transaction with a party in interest and the transaction has not been properly disclosed in the required supplementary schedule.

Appendix A of the guide includes a summary of important ERISA provisions, as well as examples of Form 5500 schedules and an annual report and audit exemption chart summarizing the reporting and disclosure requirements to which plans are subject.

New SAS on Service Organizations. The AICPA's Auditing Standards Board recently issued Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations.* SAS No. 70 provides guidance to auditors of financial statements of entities that use service organizations, such as bank trust departments that provide investment or administrative services to employee benefit plans. SAS No. 70 provides that if a user organization is affected by internal control structure policies and procedures at a service organization, the user organization's auditor may find a service auditor's report helpful in gaining an understanding of an entity's internal control structure and in assessing control risk. SAS No. 70 supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* and is effective for service auditor's reports dated after March 31, 1993.

Certifications by Trustees in Limited-Scope Audits. DOL Regulation Section 2520.103-8 permits plan administrators to elect to request auditors to limit the scope of audits of employee benefit plans with respect to certain information prepared and certified by banks and similar institutions (for example, regulated savings and loan associations or credit unions), or insurance carriers, who act as trustees or custodians. The election is available, however, only if the trustee certifies both the *accuracy and completeness* of the information submitted. Recently, certain of these organizations have failed to address completeness in their certifications, and have stated only that the information is accurate. Auditors should be aware that certifications that address only accuracy *or* completeness, but not both, do not comply with the DOL's regulation, and therefore are not adequate to allow plan administrators to limit the scope of the audit.

It should also be noted that the "limited scope" audit provision does not apply to assets held by a broker/dealer or an investment company, nor does it extend to benefit payment information.

Cafeteria Plans. Many employers have established welfare benefit and fringe benefit plans that allow employees to choose from among a number of benefit options. Options frequently include medical, surgical, hospital, sickness, accident, disability, child care, severance, vacation, legal service, apprenticeship, and training benefits. Such plans are commonly referred to as "cafeteria plans." Most cafeteria plans do not require that the assets from which plan benefits are paid be set aside in a separate trust. However, since such plans frequently require employee contributions, they may be subject to the financial reporting and audit requirements of ERISA. The DOL is currently developing guidelines to help resolve issues that have arisen in practice regarding which cafeteria plans are subject to ERISA's requirements. Current guidance concerning plans that are subject to ERISA's requirements can be found in the summary of ERISA and related regulations in appendix A of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans.*

Auditor Independence. ERISA Section 103(a)(3)(A) requires that an accountant retained by an employee benefit plan be "independent" when auditing plan financial information and rendering an opinion on the financial statements and schedules of a plan required to be included with the Form 5500 filing.

Interpretive guidelines adopted by the DOL in 1975 for determining when an accountant is independent state that an accountant can perform actuarial analyses but that an accountant who maintains "financial records" for an employee benefit plan is not independent with respect to the plan. The term *financial records* is undefined in the DOL guidelines. The AICPA's Code of Professional Conduct permits the auditor to perform certain routine services for an employee benefit plan, which may be in conflict with the DOL's rules. The auditor may wish to consult with the DOL regarding any questions he or she may have related to auditor independence when services other than auditing are provided to an employee benefit plan (for example, recordkeeping or appraisals).

Accounting Issues

Valuation of Insurance and Investment Contracts. The Financial Accounting Standards Board (FASB) has issued an exposure draft of a proposed amendment to FASB Statement of Financial Accounting Standards (Statement) No. 35, *Accounting and Reporting by Defined Benefit Pension*

Plans, that would require fair-value reporting for all investment contracts held by defined benefit pension plans. However, the proposed amendment would permit the continued use of contract value for insurance contracts as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as well as deposit administration and immediate participation guarantee contracts entered into before March 20, 1992.

The FASB's Emerging Issues Task Force (EITF) addressed issues relating to the financial statement valuation of GICs and other instruments with similar characteristics, such as BICs and SLICs, in Issue 89-1, *Accounting by a Pension Plan for Bank Investment Contracts and Guaranteed Investment Contracts.*

The EITF did not reach a consensus on the need to change the accounting for GICs or to adopt similar accounting for BICs, SLICs, and similar investments. Some EITF members were concerned about allowing different accounting treatments for similar instruments. However, most EITF members agreed that the exception in FASB Statement No. 35 to allow fair-value presentation for investments in pension plan financial statements applies only to GICs and not to contracts issued by non-insurance entities. The EITF did not address the valuation of investment contracts of any kind, including GICs, in the financial statements of defined contribution plans or health and welfare benefit plans.

In March 1992, the AICPA's Employee Benefit Plans Committee added to its agenda a project on the accounting by defined contribution plans and health and welfare benefit plans for GICs and similar contracts issued by entities such as banks, savings and loans, and thrift institutions, in order to evaluate the appropriateness of the fair-value exception for insurance contracts held by these plans, and to provide guidance for accounting for these investments. In addition, the Committee will consider how fair value for these types of contracts should be determined, including what circumstances, if any, might indicate that contract value approximates fair value. Practitioners should be alert for guidance issued in this area.

Reporting GICs Issued by Troubled Insurance Companies. The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* permits the reporting of GICs held by employee benefit plans at the value determined on Form 5500, Schedule A, "Insurance Information" (that is, contract value).

In the current economic environment, certain GICs may have been issued by what are now troubled insurance companies. When this is the case, the auditor should be aware that continuing to carry these assets at contract value may not be appropriate. Auditors should consider the guidance in FASB Statement No. 5, *Accounting for Contingencies*, when addressing problem contracts.

Health and Welfare Benefit Plans. The AICPA's Employee Benefit Plans Committee issued a proposed statement of position (SOP) on accounting and reporting by health and welfare benefit plans. The proposed SOP, which is expected to be finalized in mid-1992, clarifies several accounting and reporting requirements set forth in chapter 4 of the Audit and Accounting Guide *Audits of Employee Benefit Plans* and will update the guide to incorporate new Statements issued by the FASB. Significant proposed changes include clarification of—

- The objective of financial reporting by defined benefit health and welfare plans.
- How defined benefit health and welfare plans, both single-employer and multi-employer plans, should account for and report benefit obligations, including postretirement obligations.
- The requirement to recognize claims incurred but not reported.
- The stipulation that benefit obligations should not include death benefits actuarially expected to be paid during the active service period of participants.
- The distinction between defined contribution health and welfare plans and defined benefit health and welfare plans.
- The requirement that the current insurance premium rates used in determining the obligation for accumulated eligibility credits generally should consider mortality rates and the probability of employee turnover.

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This audit risk alert supersedes *Employee Benefit Plans Industry Developments—1991*.

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform as described in *Audit Risk Alert—1991* (No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter.* Additional copies can be obtained from the AICPA Order Department.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 334-6961 (outside New York) or (800) 248-0445 (New York only). Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.